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IN THE

# Supreme Court of the United States

OCTOBER TERM, 1957

**No. 1045**

IN THE MATTERS

*of*

THIRD AVENUE TRANSIT CORPORATION, *et al.*,
*Debtors.*

JOHNSON FARE BOX COMPANY,
*Petitioner,*

*against*

LESTER T. DOYLE, as Trustee in Reorganization, etc.,
*Respondent.*

## BRIEF OF REORGANIZATION TRUSTEE IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

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June 19, 1958

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## BRIEF OF REORGANIZATION TRUSTEE IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

### Introductory

Johnson Fare Box Company (hereinafter "Johnson"), seeks a review of a judgment of the Court of Appeals for the Second Circuit, which unanimously affirmed an order of the District Court for the Southern District of New York, Hon. Edward J. Dimock presiding, in proceedings for the reorganization of Third Avenue Transit Corporation and its principal operating subsidiary, Surface Transportation Corporation of New York (hereinafter "Surface"), pursuant to Chapter X of the Bankruptcy Act. The order denied Johnson's claim for priority under the so-called "six months' rule" for the unpaid balance of the purchase price of 225 new fare boxes in the sum of $43,491.

## The Question Presented

Did the Court of Appeals and the District Court, on the facts of this case, err in denying priority (over lien holders and other creditors) to the claim of Johnson for the unpaid balance of the purchase price of fare boxes, representing an extraordinary program for the replacement of equipment, under the rule according priority to certain claims for labor, supplies and repairs incurred within six months of the appointment of the reorganization trustee?

## Statement

The statement on behalf of petitioner fails to adequately distinguish between those facts which were stipulated (3a-20a) and the speculation of petitioner's counsel.*

The facts are fairly set forth both in the opinion of Judge Dimock (46a-48a) and in the opinion *per curiam*** of the

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* *E.g.*, referring to difficulties in the operation of buses without efficient fare collection equipment, counsel asserts (p. 5): "This practice opened the door wide to dishonesty and peculation on the part of the bus operators." No such "fact" was stipulated and no such evidence was presented.

As counsel proceeds, his enthusiasm mounts. Entirely without reference to any evidence, counsel refers to impending "early disaster" (p. 17) to "consequent jeopardy of the safety of the traveling public", and asserts that "the *safety of the traveling public* (italics petitioner's) was likewise jeopardized (p. 13)."

It is clear that the acquisition of improved fare collection devices was desirable. It is equally clear that from the institution of the 6¢ fare in September of 1948 and the 7¢ fare in November of 1948 Surface was able to operate with its existing equipment for a considerable period of time. This is obvious from the fact that, although the total of the fare boxes sold by Johnson and borrowed from the City of New York was less than was required for a complete replacement of the fare collection devices, operations did continue without interruption (Exhibit D; 24a-26a).

** Judges Clark, Moore and Smith.

Court of Appeals (250 F. 2d 656; App. A 25-27). The Court of Appeals stated:

> "Between February 7, 1949 and June 10, 1949 Johnson Fare Box Company (referred to as 'Johnson') sold and delivered to the debtors 225 new fare boxes for use on their buses. The purchase prices of these fare boxes totaled $43,533.84. On June 21, 1949 trustees in bankruptcy were appointed for the debtors. Thereafter Johnson filed with the trustees claims for the purchase prices of these fare boxes, and sought a priority over bondholders and general creditors (except those in similar position to Johnson) under the so-called six months' priority rule, i.e., priority given to certain types of debts incurred within the six months preceding the appointment of trustees. These new fare boxes were required because of an increase in fare from five to seven cents. The old boxes would not register the new fare correctly if a nickel and two pennies were deposited because they were designed to record a nickel as one fare and a dime as two fares. Unfortunately, a penny reacted in the box in the same manner as a dime so that the bus operator was confronted with the problem of trying to prevent the passengers from putting pennies in the box or, if unsuccessful, having more fares recorded and charged against him than passengers carried. Delay, confusion and dissatisfaction resulted."

## The Opinion of the Court of Appeals

After setting forth the facts, the Court of Appeals continued:

> "The reason or motive, however, prompting the debtors to purchase the new boxes does not supply the answer to the legal question * * *.
>
> The so-called six months' priority rule is an invasion of the established contract rights of lienholders. As an invasion the rule should be strictly contained within narrow confines and limited to the purposes which brought it into being. In summary, the rule assumes that debts contracted during a

short period, usually fixed at six months before a receivership, for labor, supplies or repairs necessary for a company's operation so redound to the benefit of the lienholders and other creditors that they should receive preferred treatment. On the other hand, new equipment purchased and new construction as distinguished from repairs would not fall within the preferred class. Thus, no matter how advantageous to the efficiency of the debtors' operations a purchase of new buses, for example, might have been, such indebtedness would not be entitled to a priority.

* * *

"* * * the only generality obtainable from an examination of the cases* is that 'the decision in each one depended upon its special facts.'

The conclusion reached by the court below that 'the fare boxes were not "labor, supplies or material" but rather "new equipment"' was a proper interpretation and application of the rule and the order appealed from is affirmed." [1]

## Argument

(1) The decision denying priority to this claim for the purchase price of an extraordinarily large amount of new equipment is clearly correct and not in conflict with any decisions of this Court, or the controlling decisions of any circuit.

(a) The language from *Fosdick* v. *Schall*, 99 U. S. 235, relied upon by Johnson, is *dictum*** which has not been

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* "*Fosdick* v. *Schall*, 99 U. S. 235; *Guaranty Trust Company* v. *Seaboard Airline Ry. Co.*, 11 F. Supp. 555, aff'd sub nom. *Union Switch & Signal Co.* v. *Powell*, 4 Cir., 84 F. 2d 25; *Crane Co.* v. *Fidelity Trust Co.*, 9 Cir., 238 Fed. 693. Compare *Southern Railway Co.* v. *Carnegie Steel Co.*, 176 U. S. 257 (allowing priority for purchases of rails) with *Lackawanna & Co.* v. *Farmers Loan & Trust Co.*, 176 U. S. 298 (decided the same day as the *Southern Railway* case, but denying priority for purchases of rails). See generally Fitzgibbon, The Present Status of the Six Months' Rule, 34 Col. L. Rev. 239."

** Italics are ours throughout.

followed by this Court in subsequent decisions, and the facts in *Southern Railway Co.* v. *Carnegie Steel Co.*, 176 U. S. 257, do not bear even a nodding acquaintance with the case at bar (*post*, pp. 9-11).

(b) There is no conflict of decisions. While certain early cases in the Fourth Circuit (*Virginia Passenger and Power Co.* v. *Lane Bros. Co.*, 174 F. 513; *Continental Trust Co.* v. *W. R. Bonsal & Co.*, 72 F. 2d 975) are out of harmony with the decisions of the other circuits, those cases were effectively overruled by the Fourth Circuit itself in *Union Switch & Signal Co.* v. *Powell*, 84 F. 2d 25, (affg. *Guaranty Trust Company* v. *Seaboard Airline Ry. Co.*, 14 F. Supp. 555), which the Second Circuit cited and relied on in this case. Hence, there is today no present conflict requiring determination by this Court (*post*, pp. 11-12).

(2) The holding that the six months' priority rule is an invasion of the established contract rights of lienholders, to be contained within narrow confines, is fully in accord with the decisions of this Court establishing the "absolute priority" rule in reorganizations under Chapter X. The application of the rule to the particular facts of a single claim is not a matter of such general importance in the administration of proceedings under Chapter X as to merit the attention of this Court (*post*, pp. 13-15).

## I

**The decision of the Second Circuit is correct and not in conflict with any decisions of this Court or the controlling decisions of any other circuit.**

**(1) The decision below is patently correct.**

Under the "six months' rule" a creditor of a utility with a claim for labor, supplies or repairs, arising shortly before the receivership, who did not extend long term credit and who relied on the income of the utility, is entitled

to a priority over other unsecured creditors and over lien holders.

This rule has its origin in the opinion of this Court in 1879 in *Fosdick* v. *Schall* (99 U. S. 235). For a period of years prior to that decision there were instances of preferential payments of pre-receivership operating expenses both in the state and lower federal courts, but usually with the concurrence of the lien holders.

The opinion of this Court in *Fosdick* v. *Schall* contained broad dictum (*post* pp 9-10) which provided the basis for assertions of priority for a wide variety of claims. On occasion, these claims were recognized by the lower courts (see *Kneeland* v. *American Loan Co.*, *post* p. 13) with the result that in this field of law some slight judicial support can be found for almost any contention.

In an earlier opinion determining the priority of a number of claims (In re *Third Avenue Transit Corporation*, 138 F. Supp. 623; 625; affd. on opinion below 230 F. 2d 425) Judge Dimock, with characteristic candor, stated:

> "* * * I must first ascertain what that rule is and then apply it. Its ascertainment is not easy. The researches of counsel supplemented by such research as has been at my command have not resulted in the discovery of any principle which would account for all of the decisions or even enough of the decisions so that one might say that there was a principle behind them.
>
> • • •
>
> "It seems to me that there is very general acceptance of a rule which will dispose of all of the questions here presented. That rule is as stated by Franklin W. M. Cutcheon, Esq., as quoted by Fitz-Gibbon [*The Present Status of the Six Months' Rule*, 34 Col. Law Rev. 230, 234-5] as follows:
>
> > '*Debts* contracted by the railroad company within a reasonably short time prior to a receivership, whether under a foreclosure bill or a creditor's bill, that is to say, within a period, usually

fixed at six months * * * *for labor, supplies or material or repairs* necessary for the operation of the railroad as a going concern, * * * *are preferred over the lien of a mortgage* * * *.*

'*Debts* of the railroad company for money loaned, for new construction, for general reconstruction (as distinguished from repairs), for the purchase of land and right of way, for additions and betterments which are not chargeable to operation, *for the purchase of new equipment*, for so-called car rentals payable under equipment trust agreements, for rentals under leases, for guarantees of securities of other corporations and for tort claims *do not fall within the class of preferred claims*, * * *.'

* * *

"The cases bear out the limitation in the rule as above stated to 'labor, supplies or material or repairs.'"

On appeal the learned District Judge was unanimously* affirmed on his opinion (230 F. 2d 425).

Other well considered decisions support the rule as stated by Mr. Cutcheon.

In *Rodger Ballast Car Co.* v. *Omaha K. C. & E. R. Co.* (8 Cir., 154 F. 629), the court supplemented its earlier opinion in *Illinois Trust and Savings Bank* v. *Doud* (8 Cir., 105 F. 123, *post*, pp. 9-10) in which it reviewed with great care the early decisions of this Court with respect to the six months' rule.

Rodger Ballast Car Co. contended that its claim for the unpaid purchase price of ballast cars was entitled to priority. In rejecting this claim the court said:

"For the purposes of this decision the concession is made that *the purchase of the ballast cars was necessary to keep the Eastern Company a going concern* * * * and increased the security of the bond holders secured by the mortgages. But neither the

* Judges Frank, Hincks and Lumbard.

fact that the consideration of a claim preserved and improved the mortgaged property * * * nor the fact that it was indispensable to keep the mortgagor a going concern * * * will give to the claim a preferential equity over the lien of creditors secured by a prior mortgage. [Citations omitted]. There is another indispensable attribute of a preferential claim. It is that its consideration was a current expense of the operation of the mortgagor incurred in the ordinary course of its business.* * *" (p. 632)

* * *

"A current expense incurred in the ordinary course of business within six months prior to a receivership is a usual expense incurred in the customary course of the business of the company. * * * There was no evidence that the company had ever bought such a lot of cars before, or that in the ordinary course of its business it was accustomed to purchase such a lot once in three months or in six months or in any specific number of months, as a part of the current expenses of its operation. On the other hand, *the record demonstrates the facts that the expense* of this purchase *was not a current or a customary, but an unusual expense,* that it was not *incurred* in the ordinary course of the business of the company, but *on an extraordinary occasion to answer an unprecedented demand and to provide for an unparalleled situation.* For this reason, the debt of the railroad company to the appellant for these cars lacks an indispensable element of a preferential claim, and there was no error in the dismissal of the petition." (p 633)

The foregoing applies with particular force to the claim of Johnson. Concededly, the claim of Johnson arose from a program of replacement of all or a very substantial part of the fare boxes used by Surface, not a "current or customary" program, but "*extraordinary*" and "*to provide for an unparalleled situation.*"

In *Crane Co.* v. *Fidelity Trust Co.* (238 Fed. 693, 698) the Court of Appeals for the Ninth Circuit denied priority

for claims for additional equipment and replacement of worn-out equipment, saying:

> "* * * Worn-out equipment, when replaced on an extensive scale, ought not to be classified as repairs, but as reconstruction. Additions to equipment are not current operating charges. Lackawanna Iron & Coal Co. *v.* Farmers' Loan & Trust Co., supra; Central Trust Co. of N. Y. *v.* Colorado, etc., Co. (D. C.) 200 Fed. 85; Toledo, etc., R. R. Co. *v.* Hamilton, 134 U. S. 296, 10 Sup. Ct. 546, 33 L. Ed. 905; International Trust Co. *v.* Townsend, etc., Co., 95 Fed. 850, 37 C. C. A. 396; Reyburn *v.* Consumers' G., F. & L. Co. (C. C.) 29 Fed. 561."

**(2) There is no conflict with *Fosdick* v. *Schall* and *Southern Railway Co.* v. *Carnegie Steel Co.***

Counsel, however, shuns mention of these persuasive authorities, (as well as the most recent decision of the Fourth Circuit, *Union Switch & Signal Co.* v. *Powell*, *post* pp. 11-12), all of which are in accord with the instant decision of the Second Circuit, and alleges a "conflict" with the decision of this Court in *Fosdick* v. *Schall* (99 U. S. 235). Counsel extracts from that opinion quotations to the effect that "proper equipment and useful improvements" and "equipment or permanent improvements" are within the six months' rule (p. 9).

Counsel fails to advise that this was *dictum* and that the *holding* of this Court was a *denial* of priority for the purchase price of railroad cars. Moreover, the dictum with respect to "equipment" and "improvements" has never been followed by this Court nor by the Court of Appeals for any of the circuits, other than in the exceptional, and now limited, cases in the Fourth Circuit (*post* pp. 11-12).

The Court of Appeals for the Eighth Circuit, in *Illinois Trust and Savings Bank* v. *Doud*, 105 F. 123, 143, after

quoting the extracts from *Fosdick* v. *Schall*, relied upon by Johnson here, said:

> "But it is an interesting fact that *these remarks*, upon which so many arguments are based for the preference of unsecured to secured creditors in the application of the income and proceeds of mortgaged property, *were obiter dicta, and* that *the Supreme Court has ever since they were delivered been industriously engaged in limiting their terms and restricting their* effect, * * *. *The decision* * * * *was far from the broad proposuion contained in the remarks we have quoted*, and was in no way supported by them."

The other case relied upon by Johnson, (*Southern Railway Co.* v. *Carnegie Steel Co.*, 176 U. S. 257), points up the absence of authority for the granting of priority for a major replacement of equipment. In the *Southern Railway* case, where priority was accorded for the purchase price of some rails, the Court found that the rails purchased were "*a very small quantity.*"

As the Second Circuit noted in the instant case, on the same day as this Court rendered its decision in the *Southern Railway* case it denied priority for the purchases of rails in *Lackawanna & Co.* v. *Farmers' Loan & Trust Co.* (176 U. S. 298). In the latter case this Court found, among other things, that the quantities purchased were "*unusually large*" (p. 317) and "*to be regarded as extraordinary expenditures*" (p. 316).

Obviously the claim of Johnson bears no resemblance whatever to the "very small quantity" of rails, to which this Court gave priority in the *Southern Railway* case.

The Johnson claim is for the unpaid balance of the purchase price of 225 fare boxes representing a replacement (within a very few months) of *almost 25% of all of Surface's fare collection devices.* It is clearly "unusually large" and not "a very small quantity".

Counsel's repeated assertions that the decision below is "directly contrary to the decisions of this Court" (p. 8) and "clearly contrary to the decisions of the Supreme Court of the United States" (p. 18), when contrasted with the actual decisions, leave counsel, at best, asserting a conflict with *obiter dictum* which, of course, is not ground for the granting of certiorari.

**(3) There is no conflict with the Fourth Circuit.**

Counsel also asserts (p. 18) that the decisions below are "clearly contrary" to the decisions of the Fourth Circuit in *Virginia Passenger & Power Co.* v. *Lane Bros. Co.* (174 F. 513) and *Continental Trust Co.* v. *W. R. Bonsal & Co.* (72 F. 2d 975). What counsel fails to say is that these decisions were effectively overruled by the subsequent decision of that court in *Union Switch & Signal Co.* v. *Powell* (84 F. 2d 25).

The *Virginia Passenger & Power Co.* case, holding that the deepening and widening of a canal in connection with the conversion of a steam electric plant to water power gave rise to a six months' claim, surely cannot be recognized as any authority outside the Fourth Circuit. Indeed it is extremely doubtful that it would be given any weight today even in that circuit.

In the *Continental Trust* case all of the claims related to supplies used in the construction or repair of railroad bridges which the court found were in a dangerous condition. The court said that the test was whether "in view of the magnitude of the business and of the replacement of old by new and better equipment, the operation crosses the line of usual and customary practice and becomes a work of extraordinary character", and concluded that the expenditures "were [not] extraordinary" (p. 981).

In a later case, the same Special Master, who first passed upon the claims considered by the Court of Ap-

peals in the *Continental Trust* case, said that his prior decision was "near the borderline" (*Guaranty Trust Company* v. *Seaboard Airline Ry. Co.*, 14 F. Supp. 555, 564-5). In the last mentioned case the Master and Judge Way denied priority to a claim for new equipment consisting in part of remote control switches which were to replace hand-operated switches. There, substantially as here, it was stipulated that the new equipment was purchased "*to increase the efficiency* of the operation of the railroad; *to speed up the schedules, and to reduce the cost of* operation." Counsel for the claimant urged that the preferential treatment given to the claims arising out of the construction of the new bridges in the *Continental Trust* case was a precedent for such priority for the equipment claims. The Special Master rejected this contention, and wrote:

> "I feel, too, that that claim, while correctly decided, was near the borderline." (p. 565)

Priority was denied to all elements of the equipment claims. The Special Master's conclusions were held to be "clearly correct" by the District Judge. On appeal (*Union Switch & Signal Co.* v. *Powell*, 84 F. 2d 25) the District Judge was affirmed and the Fourth Circuit limited the scope of its prior opinion in the *Continental Trust* case so as to exclude claims for new equipment.

Thus, it appears that there is now no live conflict among the several Circuits. The *Union Switch & Signal Co.* case is the latest expression by the Fourth Circuit. It was cited in the instant case. These decisions, together with those of the Eighth and Ninth Circuits (*ante* pp. 7-9), leave the law in this field well settled and adequately stated. Hence there is no occasion whatever for review by this Court.

## II

**The decision below is in accord with the decisions of this Court establishing the "absolute priority" rule.**

The holding of the court below that the six months' rule is "an invasion of the established contract rights of lienholders", and to "be strictly contained within narrow confines", is wholly in accord with the policy implicit in the rule of "absolute priority", wherein this Court has clearly indicated its concern for the preservation of the rights of creditors generally, and secured creditors particularly, against the claims of junior interests (see *Consolidated Rock Products Co.* v. *DuBois*, 312 U. S. 510; *Case* v. *Los Angeles Lumber Products Co.*, 308 U. S. 106; *Northern Pacific Ry. Co.* v. *Boyd*, 228 U. S. 482).

This Court, long ago, in *Kneeland* v. *American Loan Co.* (136 U. S. 89, 97) had occasion to observe:

> "• • • Because in a few specified and limited cases this court has declared that unsecured claims were entitled to priority over mortgage debts, an idea seems to have obtained that a court appointing a receiver • • • could rightfully burden the mortgaged property for the payment of any unsecured indebtedness. • • • One holding a mortgage debt upon a railroad has the same right to demand and expect of the court respect for his vested and contracted priority as the holder of a mortgage on a farm or lot. • • • It is the exception and not the rule that such priority of liens can be displaced."

An able writer in this field has also observed that "• • • further extensions of the rule must be zealously guarded against if railroads are to rely upon financing through the medium of mortgage bonds. If not, all claims will be paid before the funded debt."•

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• FitzGibbon, The Present Status of the Six Months' Rule, 34 Columbia Law Review 230, 245.

Counsel for Johnson, however, asserts that, unless the six months' rule is extended to include claims for equipment, suppliers

> "will withhold their vital credit and insist upon cash. Such a situation would obviously hasten the downfall of many companies whose finances are weak." (p. 23).

If the finances of some companies are so "*weak*" that the displacement of mortgage liens is essential for the payment of their equipment suppliers, it would seem that they are fit subjects for reorganization under Chapter X, with its attendant protection* of the rights of security holders and other creditors. It is very doubtful if the public interest would be served by the extension of a rule which permits corporate managements, presumably representing stockholders, to incur obligations which would displace mortgage liens. In fact, there is considered opinion that the rule itself has undesirable effects.** However, as the rule is limited "within narrow confines" to claims for labor, material and repairs, the potentialities for mischief are small.

## CONCLUSION

The decision below is patently correct. There is no conflict with the decisions of this Court or the controlling decisions of any other Courts of Appeals. The decision below is predicated upon the particular facts as to this

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* Judicial supervision; appointment of a disinterested trustee; participation by the Securities and Exchange Commission and creditor groups; notice to creditors and the opportunity to be heard; etc.

** "It is likely that the major effect of the six months' rule has been to enable an inefficient or dishonest management to remain in control long after it otherwise would have been superseded." Weiner, Reorganization Under Section 77 (1933), 33 Col. L. Rev. 834, 850.

claim. No question of general applicability and importance in the administration of Chapter X is presented. The petition should be denied.

June 19, 1958.

Respectfully submitted,

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